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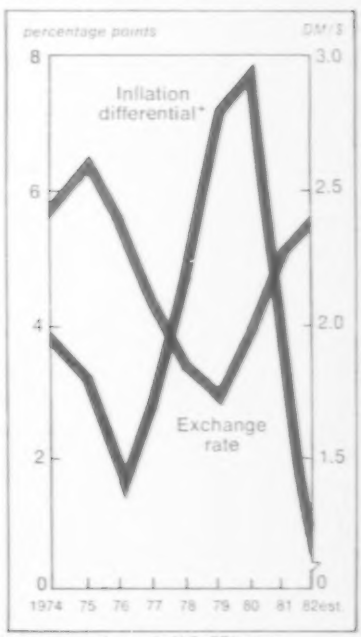
U.S. Unlikely to Lead Worldwide Reflation

Concerned that continued disinflation will intensify the current recession, leading to a further battering of the international financial system and greater unemployment and social unrest, a number of world leaders have called for a global shift to reflationary policies—led by the United States. The suggestion that the United States act as a "locomotive" to pull the rest of the world out of recession, as it did in the late 1970s, is certainly not new. But heretofore, U.S. authorities have firmly rejected such a strategy out of hand. Some analysts are now suggesting, however, that the Federal Reserve is changing its stance. They cite the recent decline in U.S. interest rates as proof that America is getting ready to reflate and may have even already begun the process.

Relative U.S. inflation and the value of the dollar



*percentage change in U.S. CPI minus percentage change in German CPI

Despite its political attractiveness, most other industrial countries have shied away from the reflation alternative because the cost to go it alone would be huge. The exchange markets are unforgiving to countries that attempt to run a divergent monetary policy and quickly pass judgment on what are perceived as inflationary actions. This is a lesson the United States learned during the last major expansion and one the Europeans and Japanese have had to relearn over the past two years. As long as it was apparent that the United States was holding fast to its anti-inflationary policies, most other countries rejected the reflationary route; to reflate without the U.S. locomotive has been deemed impossible. The question that now arises is whether the exchange markets agree with those domestic observers who assert the Fed is loosening its grip and beginning what could become "the great reflation of 1982."

So far, the exchange markets apparently do not think this is the case. The late-summer decline in U.S. interest rates has been met with dollar strength, rather than weakness. If anything, these markets are suggesting that the U.S. resolve to sustain a disinflationary policy is stronger than that of its major trading partners and that any shift toward reflation is likely to begin not with the United States but with Europe and Japan. Whether reflation is the "correct" policy is not important to the determination of exchange rates. The probability that a country will or will not reflate, however, is critical. For now, the markets are betting that the United States will be a caboose—not a locomotive—in any move toward reflation.

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British interest rates unlikely to fall further despite continuing slump.

Contrary to official forecasts that the British economy would show an early upturn, recent statistics indicate it remains firmly in recession. Industrial production turned sluggish over the summer, compared with earlier in the year. And retail sales, although about 1.5% above 1981's levels, have been satisfied as much by imports as by domestic manufactures. As a result, unemployment has continued to climb steadily, reaching 12.5% in August, and is set to rise still further. With the next election in mind, the government has shifted its policy toward giving some boost to the economy by means of reduced interest rates. Banks' base rates, which stood at 13% at the end of May, have fallen steadily to 10.5% at present. But interest rates elsewhere have also declined; thus, sterling has strengthened a little since May. The market has hopes for further reductions in interest rates. However, there are signs that the money supply is beginning to expand more rapidly, and this may prevent further declines over the near term. In addition, a strong pound remains an important part of the government's anti-inflation policy and, unless interest rates fall again elsewhere in the world, the scope for a unilateral decline of British rates may be limited.

Greek economy may force policy retrenchment in 1983.

The Greek economy continues in recession. Industrial output in the March-May period slumped some 2% below its year-earlier level, and 1982 real GNP growth is expected to be 1% at most. At the same time, the rate of inflation—measured in year-on-year terms—after falling to a low of 19.6% in February, rose to almost 23% by June, in part as a result of increases in indirect taxes imposed in the 1982 budget. Data for the first five months of the year show that the current-account deficit declined by about $379 million to $968 million. This improvement is attributable to a fall in Greece's net oil imports, partly owing to a drawdown of inventories. Non-oil exports fell while imports rose, raising the non-oil trade deficit by some $260 million in the first four months of this year. Furthermore, private capital inflows are down significantly from year-earlier levels, and the rapid rates of growth of money and credit—estimated at over 30% per annum—indicate an acceleration in the rate of inflation. These trends in turn suggest that the authorities may well adopt a less expansionary policy stance in 1983.

Brazil boosts bank reserve requirements.

In the interest of dampening import demand and easing inflationary pressures, Brazilian monetary authorities have increased reserve requirements to help contain money growth. Reserves for demand deposits have been raised to 45% from 35%, and a new 5% reserve requirement for time deposits has been instituted. Demand-deposit reserves are non-interest bearing, but the reserve requirement on time deposits may be satisfied by purchasing indexed treasury bonds. The purpose of these measures is to slow the growth of the monetary base, given the expansion of subsidized agriculutural and export credits. To be sure, achieving a strong trade surplus and stemming an inflation rate that was running at a 97.7% annual rate in August are important goals for Brazil. But the monetary measures will also mean higher interest rates and a further restraint of overall economic activity, which has been quite slow during 1982.

Indonesian development plans threatened by precipitous drop in oil revenues.

Indonesia's oil revenues have plummeted as oil prices and sales have weakened worldwide. For the period January through July, revenues were only $6.36 billion—a drop of 36.5% from the oil revenues enjoyed during the same period in 1981. The fall is attributable in part to the OPEC-imposed quota of 1.3 million barrels per day, well below Indonesia's capacity of 1.64 million b/d. The other problem is soft prices owing to slack demand now that Japan, Indonesia's biggest customer, is experiencing an economic slump. The government has resisted a price cut designed to stimulate sluggish sales. However, a sizable reduction will be needed to close the price gap that exists between Indonesian and comparable Saudi Arabian crudes. Indonesia derives some 70% of its overall export revenues from oil sales. Unless a rebound occurs soon, the government may be forced to scale back some of its ambitious development plans.

Current-account gap for Philippines expected to widen.

Because of the continued weakness of the world economy and the depression in commodity prices, the outlook for the Philippine balance of payments in 1982 remains grim. Non-traditional manufactured exports rose 17.6% in the first half from a year earlier, but total exports fell 9.9% because of continued low prices for coconut oil, sugar, copper, and other commodities. The weakness of the domestic economy held the increase in imports to just 3.1%. Still, the current-account deficit widened to $1.43 billion from $840 million a year earlier. In the past, trade figures for the first half of the year have not been very reliable indicators of final year-end results. Nevertheless, there seems little prospect for any improvement in the second half. Commodity prices show no signs of revival, and exports of manufactured goods may now be flagging because of increased labor troubles at home and greater protectionism abroad, particularly in Europe. Thus, for 1982 as a whole, the Philippine current-account deficit could widen to perhaps $3.2 billion from $2.3 billion in 1981.

Marked contraction in Saudi Arabian current-account surplus forecast.

Most of Saudi Arabia's current-account surplus—which reached a record $42.5 billion dollars in 1981—is expected to disappear this year because of sharp oil production cutbacks to defend the $34-per-barrel "benchmark" price of Saudi light crude. The surplus had widened last year from around $40 billion in 1980, despite a 19% increase in imports of goods and services plus transfer payments. This was largely due to a 12.5% rise in the average price of Saudi oil to $32.25 per barrel that boosted gross oil revenues to $111 billion (on an accrual basis) in spite of a small dip in oil output to 9.8 million b/d. So far this year, however, Saudi Arabia's oil production has fallen sharply; total production for 1982 is not likely to average much more than 7 million b/d. Consequently, even if oil prices remain unchanged during the remainder of the year, gross oil income is projected to drop 27% to $81 billion. Thus, even if payments for imports and transfers expand by a relatively modest 10% to $91 billion, the country appears likely to register a current-account surplus of no more than $6 billion in 1982.

Financial constraints confront new plan for Syrian economy.

Although Syria has only recently published its relatively ambitious Fourth Five-Year Plan (1981-85), the economy already appears to be facing financial constraints. Neither of the country's two major sources of foreign exchange this year is likely to attain 1981 levels. First, oil revenues appear to be declining because of lower prices, despite steady output (180,000 barrels per day). Syrian oil now sells for $30 per barrel as against a peak of $36 in December 1980. The fall in net oil income, however, has been mitigated by an agreement to import lower-cost Iranian oil. Second, receipts of Arab aid grants are believed to be down. The Kuwaiti Assembly voted to suspend payments to the Arab Peacekeeping Force in February 1982 and other payments were reported to have been delayed, although they are now believed to have been restored. Already the financial shortfalls are having an impact: In May all budget allocations were cut by 10% and a parallel exchange rate was established at 5.70 Syrian pounds per U.S. dollar.

Copper-market revival awaits rebound of industrial economies.

Sagging demand, weak prices, and higher operating costs have forced a rash of copper mine closings in the United States and Canada in recent months. Continued recession in the U.S. auto and housing industries has contributed to the steady decline in world copper prices to around 70¢/lb.—down by more than 22% from the already depressed levels of January 1981. At the same time, however, average break-even production costs are up by 35%, ranging from about $1.20/lb. in the United States to around 75¢/lb. among the LDC producers. The developing nations are hoping to increase copper output by some 20% in 1982 in order to meet their foreign currency requirements, and this should help to offset the U.S. cutbacks. Overall, net world production in 1982 is expected to be unchanged at about 7 million tons for the fourth year in a row. High carrying costs and low levels of business activity have kept both producer and consumer inventories at low levels. Consequently, any increases in demand will be quickly translated into higher prices over the short run.

An Interest-Rate Target for the Fed?

Bills introduced recently in the Senate and the House relating to the conduct of monetary policy have been gaining increasing attention. In essence, the proposed legislation would add an interest-rate objective to the monetary and credit aggregates now stipulated as intermediate policy targets in the Federal Reserve Act. There does not seem to be much likelihood that such a measure will be enacted during the final days of the current Congress. Nevertheless, high rates have been a major element in the economy's weakness, and further pressures to "do something" about rates will probably emerge when the new Congress convenes next January.

While both bills would require the setting of an interest-rate target, there are differences in detail. The version introduced in the House of Representatives would mandate that the Federal Reserve add long-term interest rates to its present list of targets (M1, M2, M3, and bank credit). The Senate bill is somewhat more complex. It would entail the targeting of *real* short-term interest rates—that is, rates adjusted for inflation. Moreover, rather than simply adding another target variable, this version could give rates a relatively greater policy role by requiring that money and credit targets be consistent with that for interest rates.

Fundamentally, of course, price and quantity cannot *both* be controlled. To attempt to do so, as the Federal Reserve has at times, virtually insures that neither objective will be met. Beyond this, however, at least part of the unease over monetary policy—and over the interest-rate levels to which it has contributed—has reflected concerns with what the Fed is attempting to control. Specifically, there have been serious difficulties with measuring and interpreting the aggregates, particularly M1. Over the first eight months of 1982, for example, NOW accounts (interest-bearing consumer checking accounts) constituted 92% of the total expansion of M1. As currently measured, M1 has been at or above its upper target level for virtually the whole year. A portion of the NOW account growth undoubtedly performs the function of a non-transaction holding (which would not be included in M1), although how much is open to question. Nevertheless, a better measure of the growth of "true" transactions funds—or a different target—could have meant less monetary stringency during 1982 and lower interest rates.

The elimination of restrictions on deposit pricing—ceilings, minimum maturities, minimum denominations, and sterile reserves—would substantially reduce incentives for the development of new instruments to act as substitutes for those subject to regulatory constraints. Unfortunately, there appears to be little prospect for the necessary legislative action in the foreseeable future.

Richard C. Aspinall

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981					BALANCE OF P
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IM credit, mi lions of doll
Austria	Both domestic and foreign orders declining; 1982 real GNP forecast revised down to 1.5%.	Jan.	+ 6%	65.8	+0.1%	July	4,539	+ 1%	2.7	3
Belgium	Under continuing austerity program, budget deficit to be reduced to 10.5% of GNP in 1983 from 11.4%.	April	+ 3%	96.1	+2.0%*	July	3,731	−35%	0.7	5
Britain	Production remains flat; unemployment expected to rise further.	July	+ 1%	523.0*	−1.9%*	July	13,143	−17%	1.5	113
Denmark	Economy continues to grow at moderate pace.	May	−14%	55.9	+0.2%	July	1,973	−31%	1.3	0
Finland	Activity continues to slow but 1982's GDP will still post an increase over last year.	April	− 2%	47.8	+1.0%	July	1,145	−26%	1.0	31
France	Budget proposals for 1983 underline less expansionary economic policy.	June	− 1%	657.0*	+1.6%*	June	15,178	−40%	1.5	0
Germany	Both industrial orders and production decline sharply; official forecasts for real growth revised downward.	July	− 6%	689.4	−0.3%	July	40,992	−14%	3.0	0
Greece	Output remains flat, but inflation set to rise.	May	− 5%	37.7	+1.6%*	May	828	+ 5%	0.9	4
Ireland	Tough policies now being reflected in falling production index.	May	+ 1%	17.6*	+1.9%*	July	2,669	+21%	3.0	0
Italy	Economy remains flat; fiscal policy tightened in response to rapidly rising public-sector deficit.	June	− 3%	350.6	−0.2%	July	15,355	−14%	1.9	0
Netherlands	Negotiations expected among major parties on formation of coalition govt. following recent election.	May	− 2%	139.0	−1.1%	July	8,286	− 8%	1.7	0
Norway	Reduced oil production will lead to a 1% fall in GNP relative to 1981.	June	− 2%	55.6	+0.8%	July	6,652	+21%	5.0	0
Portugal	Constitutional revision could bolster private sector.	Jan.	+ 7%	23.5*	+5.5%*	June	488	−15%	0.6	19
Spain	Economic outlook uncertain owing to upcoming election on October 28.	March	+ 3%	213.1*	+1.2%*	May	8,948	−10%	3.3	70
Sweden	Some growth is expected for 1982 but the economy is slowing.	May	− 1%	111.6	−0.8%	July	3,243	−11%	1.4	0
Switzerland	Real GDP may fall 1%-2% this year.	March	0 **	97.8	+1.4%	July	12,320	+20%	5.0	0
Canada	Worst recession in post-war era continues; August unemployment was 12.2%.	June	−14%	274.0	+3.0%	Aug.	3,092	+25%	0.5	0
United States	Economic recovery delayed by sluggish consumer spending despite July 1 tax cut.	Aug.	−10%	2,937.7	+1.9%	July	20,078	+13%	0.9	0

1980 ** 4th quarter average over 4th quarter average

Wage Gains Decelerate

Bad news about rising unemployment in the United States has overshadowed the good news about behavioral inflationary pressures from smaller increases in earnings. Unemployment increased to 9.8% in August from 7.5% just one year ago and there are indications that the unemployment rate will move above 10% in the coming months. Meanwhile, however, the year-over-year average gain in hourly wages fell to 5.6% in July. Latest data on the first dip before the end of early 1976. Last summer wages were increasing at a pace of more than 9%. Such a slowdown if continued will not only help the prospects for further improvement in inflation but also pave the way for lower interest rates.

There are three major influences on wage-setting patterns: the level of unemployment, actual and expected inflation, and the extent of unionization. In general, when unemployment is high, lower inflation and declining unionization mean the rate of wage increase will be lower. Current inflation, as measured by the CPI, has been cut nearly in half since 1980. At the same time, employment in the nonunionized sectors of the economy has grown significantly faster than in those sectors covered by collective bargaining agreements, while overall unemployment has continued to climb. This combination (slowing of wage gains was expected).

The moderation of wage increases has been very uneven, however. For example, the two major categories that have had the slowest rate of wage increases are wholesale-retail trade and contract construction. Although unemployment in the trade sector is no higher than average, its level of unionization is far below average. Conversely, the construction industry is relatively heavily unionized but it is experiencing more than 20% unemployment. In fact, with this depression-level unemployment, it is somewhat surprising that wage gains in the construction industry are as high as they are.

These general influences not only affect wage gains in other industries but hold for occupational groups as well. Wage increases for largely nonunion white-collar office workers, whose unemployment has increased only about one percentage point in the past year, have fallen just one-half percentage point. Wages of heavily unionized blue-collar workers, who have experienced the sharpest rise in unemployment from 9% to 14.2%, have slowed about one-and-a-half percentage points. And service workers, mostly unrepresented by unions, have had only a slight rise in joblessness while their wage gains have slowed by nearly two percentage points.

The outlook for wage increases for the next year or so is for continued moderation. Inflation is likely to fall further, and any economic recovery that takes hold is unlikely to be strong enough to lower the unemployment rate significantly. Thus, average wage increases are likely to fall below 5% by the middle of next year.

Douglas L. Bendt

MENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate△	exchange rate in U.S. dollars Sept. 22, 1982	current monetary conditions	
s	current influences on payments	latest data	consumer prices	latest data	money supply(M1)				
	Jan.-July current-account surplus was 3.5 bn. sch., major reversal from year ago.	July	+ 6%	June	+ 4%	6.75%	.05635	Discount and Lombard rates reduced by 0.5 percentage pt.	Austria
	Devaluation improves competitiveness of Belgian goods, reducing trade deficit.	July	9%	March	+ 3%	12.50%	.0208	Interest rates eased.	Belgium
	First half 1982 showed a £1.2 billion surplus, vs. £4.7 billion year ago.	Aug.	+ 8%	June	+ 14%	10.63%	1.7175	Interest rates down sharply since June.	Britain
	First half 1982 current-account deficit was kr 10.72 bn., vs. kr 5.84 bn. in '81.	June	8	Feb.	+ 13%	11.00%	.1143	Kroner speculation preventing interest-rate decline.	Denmark
	Current-account surplus of fmk 482 million in the first half of 1982.	July	+ 10%	May	+ 20%	8.50%	.2083	Current anti-inflationary stance expected to continue.	Finland
	Current-account deficit of around FF 50 billion expected in 1982.	Aug.	+ 11%	April	+ 16%	9.50%	.1419	Less speculation against FF may allow interest-rate cuts.	France
	Current account continues to improve on shift in terms of trade.	Aug.	5%	June	+ 4%	7.00%	.4008	Lombard and discount rates reduced.	Germany
	Lower oil bill reduces current-account deficit.	June	23%	Dec.	+ 22%	20.50%	.0158	Money and credit continue to expand rapidly.	Greece
	Trade deficit was £779.9 million over Jan.-July, vs. £1.1 billion year ago.	May	+ 21%	June	+ 6%	17.50%	1.3700	Prime rate down to 16% from 19% in August.	Ireland
	Jan.-June trade deficit was 9.9 billion lira, vs. 10.9 trillion year earlier.	Aug.	+ 17%	March	+ 7%	18.00%	.000711	Discount and prime rates reduced by 1 percentage pt.	Italy
	Current account remains in surplus; natural gas exports may be raised.	June	6%	May	+ 3%	7.00%	.3666	Interest rates fall in line with German rates.	Netherlands
	Current account still in surplus but sharply reduced owing to falling oil revenues.	July	+ 12%	April	+ 9%	9.00%	.1443	Relatively high inflation again forces 3% kroner devaluation.	Norway
	1982 current-account deficit forecast to exceed $2 billion.	May	+ 25%	Dec.	+ 9%	19.00%	.0120	Inflation still above 25%.	Portugal
	Jan.-June current-account deficit was $3.2 billion, vs. $4.1 billion year ago.	May	+ 15%	May	+ 16%	8.00%	.00889	M3 growth rose to 17.4% in June.	Spain
	Jan.-June current-account deficit was kr 5.1 billion, vs. kr 4.3 billion year ago.	July	8%	March	+ 9%	10.00%	.1606	Monetary policy remains restrictive after July tightening.	Sweden
	Export volume contracting.	Aug.	+ 5%	May	+ 1%	5.00%	.4678	Central bank easing has led to pick-up in money growth.	Switzerland
	Credit line available to boost C$ expanded by $2 billion.	Aug.	+ 11%	April	0	13.42%	.8150	Money remains tight; M1 virtually unchanged this year.	Canada
	Exports held down by continuing world recession.	Aug.	+ 6%	Aug.	+ 6%	10.00%	—	Money growth accelerates; rising interest rates feared.	United States

△most recently reported

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World Interest Rates

market rates as of Sept. 22, 1982; bond yields as of Sept. 17, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	13.42	10.625 intervention rate	12.50	9.50	7.00	18.00 penalty rate 21.00	7.00	5.00	5.50
Day-to-Day Money	10.25 September 23	15.50	11.00	11.95	14.125	8.00	18.50	7.75	7.25 1-month Euro Swiss fr. rate	6.9375
Treasury Bills 91-day, Middle Rates	7.37	12.90	10.25	12.75	n. a.	n. a.	16.503 79 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.50 finance paper discount basis	13.25 finance paper 15% tax w/h	10.011	12.40 Certified	14.3125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.30	13.00 15% tax w/h	10.125	12.40 Certified	not traded	8.50	21.00	no market	4.25	no market
Government Bonds Long-term, new and old issues, average yield	12.04	13.95	11.23	9.944 20% tax w/h	15.66	8.65	19.20	9.93	4.47	8.15
Industrial Bonds prime, long-term, new and old issues, average yield	13.85 Aa Industrials	14.75	12.72	15.20	16.34	8.69	19.83	10.82	5.87	6.66
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	15.50	11.50	16.25	16.05	11.50	20.75 ½ qtrly fee on outstdng.	9.50	8.00	6.00
Bank Time Deposits 3-month	10.125 Cert. of Dep.	12.85	10.6875	12.60	14.375	8.15	11.50	8.00 large deposits	3.25 residents only	3.75
Eurocurrencies 3-month, asked	11.75	13.00	11.00	no market	19.25	7.625	no market	7.875	4.1875	7.4325
Exchange Rates—in U.S.$ rates floating against the $	—	.8150	1.7175	.0208	.1419	.4008	.000711	.3666	.4678	.00381
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.50 *D*	1.00 *P*	1.25 *D*	8.00 *D*	4.00 *P*	8.50 *D*	3.75 *P*	7.375 *P*	4.375 *P*

Eurodollar Deposits
(London, interbank, bid)
September 23

7-day	10.5625
1-month	10.9375
3-month	11.5625
6-month	12.3125

International Arbitrage
(3-month, hedged) ✣ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−3.739
U.S.-Canada Treasury Bills	−3.457
U.S.-Canada Finance Co. Paper	−1.068
Eurodollars-U.K. Local Auth. Deposits	+0.125

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.375
Over 7 yrs.	13.00
DM Bonds	
7 yrs. and under	8.625
Over 7 yrs.	8.875

Gold Price
London afternoon fixing
443.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Aug.) 5.9	(Aug.) 10.6	(Aug.) 8.0	(Aug.) 10.9	(Aug.) 5.1	(Aug.) 17.2	(Aug.) 5.2	(July) 1.7
Industrial production*	(Aug.) −10.2	(June) −14.0	(July) 0.6	(June) −0.8	(July) −5.6	(June) −3.0	(March) 0	(July) 0.7
Trade balance† *(billions of local currency units)*	(July) −$2.42	(July) C$1.56	(July) £0.17	(Aug.) −FF8.98	(July) DM3.70	(July) −Lit.730	(Aug.) −SF0.78	(July) ¥594
Money supply (M1)*	(Aug.) 5.6	(April) 0.3	(June) 13.5	(April) 15.5	(June) 4.0	(March) 7.3	(May) −0.9	(May) 6.6
Velocity of money (M1)*	(June) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Dec.) 0**	(March) 3.1	(Dec.) 7.6**	n. a.	(March) −4.5
Reserves minus gold *($ million, change from previous month)*	(July) 560	(July) 344	(July) 239	(June) −597	(July) −811	(July) 1,030	(July) −1,015	(July) 183

* Percent change from 12 months earlier.

**based on GDP

† Figures are only for the month indicated.

Japan's Changing Financial Markets

(Last of a three-part series)

Despite radical changes over the past decade, the transition of Japan's financial system, in response to extraordinary developments in Japanese foreign and domestic economic policy, is in many respects just beginning. How the system evolves over the next several years will depend primarily on how fast and to what extent restrictions on Japanese interest rates are eliminated.

At present, the huge volume of new debt the government must issue to finance its growing deficit represents the biggest stumbling block to the emergence of a truly free financial market—in which interest rates are determined by the demand and supply of funds. Policymakers are strongly resisting attempts to liberalize the terms of new bond issues, as such a move would inevitably mean a sharp increase in the interest burden of servicing the government debt. And yet, underwriting syndicates have become increasingly reluctant to accept new government issues at existing below-market terms. Over the past year in particular, high U.S. interest rates have pulled up secondary market yields, leaving underwriters highly vulnerable to onerous capital losses if they are subsequently forced to sell the bonds. As a result, the government's difficulty in selling bonds is putting severe pressure on policymakers to slash expenditures in order to reduce the volume of bonds needed for deficit financing. And it is also providing the impetus for a number of further changes in the Japanese financial system.

For example, Japan enacted a new banking law last April that, effectively, will help to expand the market for government bonds. Under the so-called "Amended Banking Law," banks will be permitted to sell newly issued national bonds to the public at teller windows beginning April 1, 1983. Banks hope that the bonds can be sold over the counter at a price closer to the purchase price, because issuing rates will be higher than the rates available on savings deposits. Additional changes are actually likely to occur rather rapidly, since in fiscal 1985 the government will have to start rolling over the large amounts of debt incurred in recent years. At a minimum, banks are expected to be allowed to sell old issues of government bonds.

Changes are taking place in the shorter end of the market, as well. The Bank of Japan's (BOJ) recent sales of short-term government bills at market rates, in order to soak up seasonal surpluses of funds, may well lead to the development of a full-fledged secondary bill market—and to increased pressure on the government to auction the bills at market rates.

The freeing up of interest rates will also encourage the development of Japan's private capital markets, allowing direct business financing to take on increasing importance. Moreover, pressures for the development of a domestic commercial-paper market are expected to intensify once banks and securities firms receive permission to deal domestically in commercial paper issued abroad. As new avenues open up through which firms and banks can raise funds, the traditional dependence of firms on the banks and of banks on the BOJ will diminish even further. In addition, liberalizing the market for government securities will lead to pressures for the decontrol of deposit interest rates, as government bonds are forced to compete with savings deposits. As in the United States, however, reforms in deposit rates are likely to come about slowly.

As liberalization occurs, competition among banks and between banks and other types of financial institutions is expected to intensify. And this is likely to lead to the development of new financial products. The Amended Banking Law has already stepped up the competition by allowing banks to deal in national bonds and eventually, along with securities firms, to sell foreign certificates of deposit and commercial paper in Japan.

The internationalization of the yen

Finally, the liberalization of Japanese financial markets and capital flows is likely to promote the use of the yen as an international currency. Use of the yen for the settlement of trade transactions has grown steadily over the past decade, with the share of Japanese exports denominated in yen jumping from 2% in the early 1970s to over 30% today. However, the proportion of Japanese imports denominated in yen—which is far more crucial to the development of the yen as an international currency—has remained at only 2%–3%, partly for lack of a market for bankers' acceptances.

At the same time, the yen's role in financial transactions has grown as the liberalization of capital flows has led to increased foreign investment in Japan. As government constraints on the Japanese financial markets continue to be lifted and as the menu of yen-denominated financial instruments grows, the internationalization of the yen will increase further. The creation of an offshore banking center in Tokyo, currently under government consideration, would accelerate this process. Still, the yen's role in fiancial transactions is likely to remain limited as long as the BOJ places ceilings on samurai bond issues and on banks' yen-denomiated foreign lending.

The Japanese financial system has a long way to go before it can be considered open and market-oriented. However, the changes that have occurred over the last decade and those that are likely to take place over the next several years are moving the system steadily in that direction.

Melanie L. Lau

Qatar's Well-Managed, Well-Endowed Economy

Qatar's production of crude oil fell 14% in 1981 to an average of 405,000 barrels per day—the lowest level since 1973. The rate of output thus far in 1982 has fallen still further, as world demand for OPEC oil has remained weak. And while fourth-quarter output should be buoyed by seasonal demand and by a slowdown in the rate of global inventory drawdown, average output for the year as a whole is not expected to exceed last year's average and could be smaller.

Qatar's oil prices have also been affected by the soft market conditions. Assuming prices remain at about their current level for the rest of the year, the average price of Qatari oil for 1982 is expected to be around $34.60 per barrel—down some 6.5% from last year's $37.04.

The economy of Qatar will remain heavily dependent on its oil and gas resources for many decades to come. Proven domestic reserves of crude petroleum—which generates the bulk of state revenues—are around 3.58 billion barrels. At the 1981 rate of production, these would last some 24 years. But projections published by OPEC indicate that, owing to both the slow projected growth of world demand for OPEC oil and technical considerations aiming at prolonging the life of existing fields, Qatar's oil output will drop to 300,000 b/d by 1985 and to 200,000 b/d by 1990.

Fortunately, however, Qatar has huge reserves of natural gas—a major portion of which are not associated with its oil reserves. The North Field, located off Qatar's northeast coast, is one of the largest sources of non-associated gas ever discovered. Estimates of its recoverable reserves range from 100 billion to 300 trillion cubic feet. Qatar is counting on this resource to support its long-term development.

The primary immediate effect on Qatar of the drop in oil output during the last several months has been the concomitant decline in associated gas used as fuel or feedstock for some of the country's heavy industries as well as power and desalination plants. This has highlighted the need to exploit the massive North Field gas reserves. Negotiations between the government and potential foreign joint-venture partners have been going on for some time now. At present, official expectations are that a joint-venture partner will be selected by the end of next year to take a 20% stake in the $6 billion project. Once an agreement is finalized, it will be at least six to seven years before the first liquified natural gas shipment is made.

The state budget and economic policy

The management of Qatar's economy continues to be described by observers as cautious and prudent, particularly by regional standards. Following two years of fiscal restraint to alleviate inflationary pressures—which brought inflation down to less than 10% in 1980 and 1981 from over 30% in the mid-1970s—the government's budget became more expansionary. Fiscal 1979/80 and 1980/81 saw increases in expenditure allocations of 24% and 22%, respectively.

The current budget covers the 18 months beginning October 1981 through mid-April 1983. With the exception of the recently announced scaling-back of plans to construct public buildings, there have been few signs of a sharp curtailment of planned development projects, despite speculation to the contrary. However, given that major projects have already come on stream, it is unlikely that Qatar's actual public expenditures during 1981/83 will be much higher—if at all—than during 1980/81. Public spending could, however, begin to increase once plans have been finalized for exploitation of the North Field gas reserves.

Qatar has registered current-account surpluses on its balance of payments since 1974. Soft demand for OPEC oil, however, has trimmed the surplus from a peak of around $3 billion in 1980 and 1981 to around $2 billion estimated for this year. The surplus has been further eroded by loans made to Iraq. The magnitudes of the loans involved are highly uncertain but could easily be running at a rate of $1 billion annually. Demand for OPEC petroleum is not projected to grow noticeably through 1985 or 1986, and real oil prices by then may not be higher than they are today. This, coupled with technical considerations relating to offshore fields in particular, suggests that Qatar's oil output and revenues will not grow substantially over the medium term.

Nevertheless, Qatar's foreign exchange expenditures remain noticeably smaller than current earnings. Thus, surpluses—albeit modest—could easily continue to be registered in the near term. However, a sharper-than-expected drop in oil prices, enlarged financial commitments to Iraq or reparation payments to Iran, or a marked increase in foreign exchange needs connected with the development of the massive North Field gas reserves could cause the surplus to disappear by 1984 or 1985. If so, Qatar's presence in the Eurodollar market may be felt more strongly than it has been in recent years, although the authorities are not likely to permit uncontrolled sudden expansion of public expenditures.

In general, the longer-term outlook for Qatar's economy is good: Its external public debt is negligible, and its accumulated foreign assets totaled $8-10 billion as of the end of 1981. Furthermore, the inevitable exploitation of its huge nonassociated gas reserves—in one form or another—will underpin its long-term development. These reserves are also expected to yield increased export revenues beginning in the late 1980s, and this could easily render Qatar a substantial generator of surplus funds once again. *Sharif Ghalib*